BULLETIN

of

THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

APRIL, 1931

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THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

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THE CHANGING WORLD PICTURE

By DR. STEPHEN I. MILLER, Executive Manager
National Association of Credit Men

PURELY and simply, this article will be a plea for the gaining of a perspective, for the acquisition of vision, because it is safe to say that there has never been a time when vision and an all-embracing perspective have been as important as they are today. What this country needs more than anything else today, what this world needs above all else, is vision. Had we earlier acquired a better vision w might have averted many things, one of which is the present economic depression that the world has been wallowing in for over a year. But we have gone along doggedly, learning from experience, yet seldom applying our experience to the problems of tomorrow. History repeats itself, we have been told. Still we have trudged on with little or no attempt to analyze the conditions that seemed to be rising in our path. Only when we have bumped square into immovable truths or met problems we could not dodge—only then have we seen fit to analyze our position, to trace the path by which we came, and to attempt to locate the path that will lead us back to the heights.

We need vision. Not merely foresight. Not merely hindsight. But both hindsight and foresight. Today the United

States is part of a rapidly changing world picture. To see where we are going we should turn and see whence we have come.

It is now some four hundred years since mercantilism came into the ascendant position in the commercial world. Mercantilism was the theory of economics which developed in the chief states of Europe four centuries ago as the centralization of national power evolved out of the decline of the power of feudal barons and the feudal system. In a broad way mercantilism was characterized by a policy of governmental regulation of trade and industry with foreign countries, especially, with emphasis on national rather than local aims. Mercantilism sought to build up national prosperity by insistence on a favorable balance of trade, the development of agriculture, manufacture, a merchant marine, and foreign possessions for trading purposes. Basically the working theory of mercantilism was to have greater exports than imports. That would make gold flow into the country and since gold is wealth (as the mercantilists argued) the land will be wealthy, self-sustaining, and prosperous.

Mercantilism has been in evidence for four centuries. From it there resulted the Navigation Laws of England, tariff developments, embargo restrictions. But human beings have never held to any one thought continually. In the middle of the eighteenth century came a new theory in economics. This was the doctrine of the physiocrats. Briefly, it was based on the supremacy of natural order and taught that all wealth came from the land, that the only wealth producers were those who were connected with the land, and that that nation was wealthy which had the greatest number of people cultivating the greatest amount of land for the greatest return.

But the physiocrats erred in overlooking all those save the people who were connected with the land. What good is the grain to the farmer if it goes to the granary and gets no further? What use is the cotton, baled and ready for shipment, without a shipping unit, without a converting

unity, without a distribution unit? No, the wealth producers are not confined to those who grow the product—all those whose work is a legitimate part of the process, whereby the product gets from the farm to the table, are wealth producers. Their work is necessary and essential. Even during the ascendency of the physiocratic idea, the mercantilistic theory was never entirely eliminated. It was subordinated to the doctrine of the physiocrats for the time being.

There are evidences today that the mercantile theories are again assuming a dominant position in world thought. Truly, we have never done without them but as we look about us we see the rise of nationalism and nationalistic feelings assuming a position of paramount importance. Here is some evidence. Tariff walls in all parts of the world are being erected higher than before. Small nations, some of almost insignificant size, are endeavoring to be self-sustaining while every important nation, such as England, France and the United States, is piling up gold reserves.

That is just a glimpse of the changing world picture. What is the place of the United States in this scene? The United States, although not enough of us realize it, is the creditor nation of the world. The world owes us money. But this has not always been true. Until around 1915 we owed the world money. But since that time our increased exports, our investments in foreign bonds, the development of our carrying trade—these among other factors have made us the leading creditor nation of the world. And with that position go many responsibilities.

As the chief creditor nation of the world the United States, in my opinion, must do several things. These include the financing of foreign loans, the stabilization of foreign currency systems, the stabilization of the basis of credit in foreign trade, and the sponsoring of effective, constructive competition abroad.

The matter of foreign loans needs clear thinking. We cannot make loans unless they are sound business propositions,

primarily, and divorced entirely from politics. Although we are economically and morally bound to loan to our debtor nations these loans should be for use abroad in the interest of government stabilization, perfection of communication and transportation facilities, and the promotion of education. Loans abroad should not be made if they will build up foreign production facilities and force American producers to face unsound, uneconomical and unethical competition.

But since we make foreign loans we should not expect or demand reciprocal trade abroad on the strength of these loans alone. Credit extensions should be made without any obligation to buy from us for we must remember that we gain an indirect advantage, at least, from foreign loans. Trade is so diverse that we cannot force such obligations without causing ill-will and a consequent psychological boycott of American goods. We must compete for our business as others do, and not use the club of credit loans as an influencing factor.

Foreign loans cannot go on forever. Principal and interest payments must be met and we cannot continue increasing our loans abroad so that interest and principal payments can be made to us. How can they be taken care of by those who owe us? Imports, that is the answer to that question. We must import. Exports without imports—such a policy is impossible because exports must be paid for and imports are a primary means towards this necessary end.

These responsibilities which I mentioned in an earlier paragraph, cannot be evaded. We must build good-will abroad for today's business, for tomorrow's, and for the day thereafter. Good-will is as necessary for a nation in its commercial relations as it is for the individual. It means that when that nation enters a stage where it is not absolutely indispensable for others to deal with it, they will continue to do so and we must look forward to a possible day when the United States is eclipsed by some other land. It is visionary, as far as we who are alive now are concerned. But it is not impossible. The United States has displaced Great Britain, a nation that ruled the commercial world for the past few centuries. History's

acts and lessons are worth a second look, for Great Britain replaced Spain, Spain took the leadership from the Italian cities, and so it has gone.

We must build good-will abroad if our foreign trade is to exist and to last. That is almost axiomatic. Politicians abroad can swing their people around to an anti-United States feeling on the well-worn indictment of money-hungriness, which arises from the fundamental fact that these people owe us money. Such feelings are prevalent today, as the press and travelers have observed and are observing.

These feelings arise because a debtor nation has a different psychology than a creditor nation. During the years before 1915 when this country was debtor nation, we showed some of the same signs that we now observe in foreign lands. It results in high tariff walls which are now being erected in many parts of the world. Portions of our own tariff system are a hang-over from the debtor nation psychology by which we were once controlled.

However, I do not present a blanket indictment of our tariff regulations. A tariff is necessary at times of economic chaos abroad, in case of war threat, or in the possibility of competition from abroad by means of state production, such as a communistic system develops. A tariff is necessary so long as nationalistic principles are paramount. An international viewpoint is admirable but we cannot justify or maintain such a position while other nations are acting on a nationalistic basis in their commercial relations with us and others.

The current depression has not been entirely negative in its characteristics. It has seen the development of this internationalism, of which we speak, in a different manner than heretofore. Trade groups, both national and international, have grown in recent months and indicate an understanding of the necessities and benefits to be gained from world-wide cooperation. Industries are brought together by a need for the better understanding and control of credit conditions, by

problems arising from over-production, and by faulty systems of distribution, among others. These groups, I believe, will be the vehicle for future world trade. They will regulate production and distribution, both as to quantity and as to who shall take part. They will be in many respects like the trade guilds of medieval times in their control of the product they are concerned with. They may even cause a lowering in tariff walls with tariffs based on sane economic principles rather than on biased political foundations as is often true at present.

But these same groups may also cause increased international competition if they are strictly national and selfish in reaching out for portions of the world's trade. Such national alignments could tend to give emphasis to product competition between countries and result in more intense tariff regulations than are now existent.

Here is part of the changing world picture. It is only a part. Space limits deny further excursion into the realm of what-is and what-may-be. But we will have gained much if we can focus our glance on this portion of the scene, study it intently and intelligently, and deduct from it the fundamental truths on which our actions and our place in the world picture of tomorrow will be based.

ACCOUNTING AND THE STOCK EXCHANGE*

By J. M. B. Hoxsey, Executive Assistant,
Committee on Stock List, New York Stock Exchange

I FEEL very much honored to be asked to address you to-night, particularly when it has been understood by your entertainment committee that I should be unable to do more than to restate, extemporaneously, what I have already said elsewhere, and to add to it a few matters that have come up for more or less intensive consideration since the date of the address to which reference has been made.

It is necessary to distinguish rather carefully between the official position of the Stock Exchange, as such, and certain of the views which I shall advance as being those held by myself personally. And I should like to say in advance, so there may be no misunderstanding, that the official position of the Stock Exchange is set forth in various printed announcements that it has made. Anything else that is stated should be taken as unofficial.

The thing that interests me about the particular subject we have for discussion is that accounting may not have evolved as fast as business practices have evolved.

As I, speaking from the standpoint of a looker-in on accounting matters rather than an accountant myself, see the situation, accounting for many years was confined more or less to the furnishing to management that information which was necessary for the proper management of a concern and to furnishing to the creditors that information which was necessary to pass upon the amount and character of the credit extended.

Now with the great extension of corporate ownership among the people with which we are all familiar, a third factor has come in and has assumed second importance and that is, the furnishing to the stockholder in intelligible form,

* An address delivered at a meeting of The New York State Society of Certified Public Accountants, held in New Yoik City, April 16, 1931.

readily understood by the ordinary man, such information as will give him an opportunity properly to value the investment which he holds.

For instance, it has often been said by one of your number, and I endorse that most heartily, that an income account serves two purposes. First, it is an historical record of what has passed, and second it is an indication of what future earnings may be expected in so far as the past may be held to be a guide to the future.

In that second matter particularly the Stock Exchange is very much interested because what we try to do there is to give a fair, free and open market where all who deal in securities handled may do so upon equal terms.

Depreciation

The order of subjects chosen for this address must necessarily be more or less scattered because they are more or less unrelated. I think perhaps the point upon which accountants differ more from each other in their practices is that of depreciation. In fact, I have sometimes thought that there were almost as many theories of depreciation as there were corporations.

Now whatever else depreciation may be, whatever theory is right or wrong, depreciation is certainly a function of plant and not of earnings. While application of a percentage of earnings may be a more or less useful yardstick, yet the actual amount of the depreciation if it is to be found at all accurately must be taken in relation to the value of the depreciable property, its life in service, the cost of dismantling and its gross salvage value.

I am not in sympathy at all with the thought that the character of ownership of property determines the amount of depreciation. I can see no reason why property of a given character should not depreciate under similar conditions of use equally whether held under one character of ownership or another. And I wish to point out that it is the particular

component parts that depreciate. It has always seemed to me that the theory that a plant of any sort should be considered as a whole, and that when maintained at a certain standard of excellence no depreciation occurs, is wrong because each individual component element of that plant will in course of time deteriorate, depreciate, be superseded—obsolescence, inadequacy, public requirement or whatever the cause may be, and the funds must be provided for that retirement in advance.

If the corporation sets aside a reserve for the equalization of retirements only I want to point out very strongly that they do not under such circumstances at any time have in reserve an amount equal to the degree of depreciation upon the property then standing and in service. And therefore, in order that accounts of different companies may be comparable, accountants should, I think, state in their certificates or otherwise, as nearly as may be the basis of depreciation adopted by the corporation.

I have known corporations to change that basis two or three times in the course of a year. I have known them to change from charging the depreciation on continuous structures, the retirement of continuous structures through the depreciation account, by taking it out of that and charging it to current maintenance; known them to raise from time to time during a year the size of the units which are passed through the depreciation account as distinguished from the current maintenance account, and those things are confusing.

Wherever that is done, it should be definitely and clearly stated in order that the public reading the reports may know just what and how much the depreciation account means.

Personally, I feel that one year is a normal accounting period in this country, and that the replacement of all parts whose normal life is more than one year should be passed through the depreciation account. However that may be, the different standards should be set forth.

The determination of what the rates of depreciation are has always seemed to be more strictly an engineering than

an accounting matter and I feel that accountants may well rely upon the advice of competent engineers in this respect and qualify their certificates in regard to it only in cases where there are no such engineering reports or recommendations available and where the percentages vary materially from those widely in use.

The subject is one of tremendous importance as for instance it is perfectly easy to set up an example of a somewhat but not unduly pyramided capital structure where we will say the true rate of depreciation is known to be 2½ per cent on the depreciable property. Should the rate under the structure which I have in mind be reduced to 1.8 per cent which is well within the bounds of the difference that exists between many companies, the earnings of the common stock of the holding company would be increased from nothing to 10 per cent upon the amount of the stock. Decrease it to 1.1 per cent from the original 2½ and the common stock appears to earn 20 per cent instead of nothing when using the true rate of depreciation.

By the way, before I go any further, I want to say this, that in order not to consume time and to avoid apologies, I am going to make the statements which I have to make somewhat dogmatically assuring you all in advance of my deference for any counter-opinions.

Consolidated Accounts

Among other things which I touched on in Colorado Springs was the subject of consolidated accounts. I voiced there the thought that there should enter into the consolidation all subsidiary companies, more than fifty per cent of whose equity stock was held by the holding company. As a result of that meeting there was appointed a committee of the American Institute of Accountants for cooperation with stock exchanges.

Generally speaking, I believe that committee is in agreement with most of the things advanced in the paper but upon

that particular matter they were adamant in refusing to agree. Personally of course I know that they are all wrong, but however that may be, what the Stock Exchange is trying to do is to get a consensus of opinion as to what are proper accounting methods and practices, and if we can not convince a committee of the most eminent accountants in the country that our position has been right on that then there is nothing to do but to cease butting our heads against a stone wall and change our requirements, and therefore since we have learned the views of these accountants on that we have changed the requirements of the Listing Committee and no longer require the same degree of consolidation as we have done heretofore, but are satisfied if the effect of the undistributed earnings of unconsolidated subsidiaries is shown upon the report submitted either as an element in the consolidated income account as a separate item with of course appropriate valuation of the assets thereby effected in the consolidated balance sheet, or if not there, at least in a footnote.

We do still insist however that the net result at least of operation of the system as a whole should be made fully known to the stockholders and we found no accountant who disagreed with that view.

Volume of Sales or Gross Income

One of our most difficult subjects is to induce the corporations to submit in their income statements the volume of sales or gross revenue. Now the balance sheet is declining in relative importance; sometimes I think it is becoming little more than a device for proving the accuracy of the income account, and the income account, as men value securities more and more upon the basis of earnings and less and less upon the basis of assets, is becoming the important feature.

I do not need to say to accountants, I think, perhaps you will all agree with me when I say that sales or gross revenue, according to the character of the institution or corporation, is next in importance to net profits in the figures which a corporation can show to its stockholders. It is the key to

the analysis of almost every element of the effectiveness of management, and without it the stockholders are simply at an utter loss fully to appraise the progress or retrogression of that management.

There are cases in which it is harmful to the corporation to make that information public. I have very little sympathy with those corporations that do not wish to make it public on account of the advantage which it gives to their existing competitors.

From such contact as I have had with manufacturing and similar corporations, that corporation which does not know approximately the volume of sales of its competitors deserves what is coming to it. They keep it from stockholders but under such conditions they do not and cannot keep it from their competitors.

I have much more sympathy with the thought that sometimes in business where the gross profit is relatively large, a statement of it may tend to invite additional competition, new and ill-informed competition, into the field. That is a real point and again there is sometimes in certain types of business, particularly those dealing with a few highly organized customers, an element of sales resistance caused by the publication of the amount of sales and cost of sales which it is to the advantage of the corporation and therefore of its stockholders to avoid.

Now our position is of course that while information is valuable it does not necessarily take the place of money and that if the choice were deliberately afforded to a stockholder as to whether he would have more information or larger dividends he would probably choose the latter. Therefore we are not requiring corporations to furnish that information when the Committee on Stock List is convinced that to do so would be inimical to the best interest of the stockholder, but I am confident there are many instances where the allegation is made and supported vehemently where that is really not the fact and where it is more a hidebound conservatism in not

wishing to show the figures than otherwise and I want to ask you accountants, as often as you can to cooperate with us. You see this thing at its source. Unless you yourselves are convinced that some injury is caused to the corporation by showing the information, urge them that that information should be included in their reports.

Other Income

Another thing is that the Other Income of a corporation should always be shown separately from its operating income, and that the Exchange is disposed to insist upon very strongly, and even to the extent of a detailed statement of the major items if they are particularly large in reference to the total revenue of the corporation.

We also feel that while every corporation has in its accounts annually a number of non-recurrent items, any unusual or large non-recurrent item should be shown. I happen to know of one corporation operating at a loss of $900,000 during a given year, which took into its accounts in that year a non-recurring but true element of profit of $3,600,000 without disclosing it, showing a total profit of $2,700,000. Manifestly such a thing as that is not defensible at all.

Surplus and Surplus Entries

The surplus statement we regard as of very real importance and we suggest for the consideration of accountants that they consider the term capital surplus as a generic one embracing all forms of surplus other than undistributed earnings. I do not care whether it is paid in surplus, surplus arising from appreciation or re-valuation of assets, or surplus of other companies at the date of acquisition. Very few of the most decent corporations, while the laws of the states under which many of them operate permit them to declare dividends without disclosure from capital surplus or from paid in surplus, do so, at least as regards their common stock, in cash.

The earned surplus is the limit beyond which dividends of any conservative corporation that I know of go. And the

stockholder is entitled at all times to know the amount of the undistributed earnings of the corporation from date of organization until the date of the report, or if there has been a recapitalization of the corporation wiping out past losses or anything of that sort, then from some specific date of recapitalization duly set forth in the report.

This matter is also of importance to us in dealing with another subject, that of stock dividends, to which I shall refer.

We feel that entries, the direct entries to the surplus accounts, should be kept within the narrowest possible limits. Every accountant is familiar of course with entries which must and should go through the surplus account, but to the extent that they affect operations for the year, even in case of marked reductions in inventory valuations or anything of the sort, it appears to us misleading to include them in the surplus account rather than in the regular operating account.

A particular objection which we have and which the Committee has often voiced officially is to taking up the surplus of an acquired company as an element of earned surplus. It is true that in cases of a true legal merger as distinguished from an acquisition of stock or a purchase of property, this can properly be done. As a lawyer once phrased it to me, the new corporation is in effect the family resulting from the marriage of two individual corporations, but the identity of the individuals persists. But where a corporation buys the stock of another corporation it pays for it a price based upon all of its assets and its earning power and that price is not in any way affected by the proportion of the assets that may have come originally from the acquired corporation's stockholders and the portion of the assets which may represent a reinvestment of earnings.

Likewise when the property of another corporation is acquired it might be at more than its reproduction value because it may have attached to it an earning power which justifies it, but whatever it is, it is the property as a whole that is acquired and the securities issued therefor represent it, as is,

upon the date of acquisition, and it is impossible to transfer to a new corporation not resulting from consolidation or merger any true earned surplus.

It is true that if there should be in the mind of anyone a good reason, under the laws of most of our states making discretionary that proportion of the consideration received for stock which a corporation may declare to be capital and that proportion which it may declare to be surplus, it is perfectly possible to treat an equivalent amount to the earned surplus of the acquired company as an element of capital surplus. Personally, I think it is rather amiss to do even this. There are certain uses which capital surplus has — no objection within limits to the setting up of a proper amount of capital surplus, but to avoid misapprehension and confusion of thought, I think it is very well not to make the basis of distinction between capital and capital surplus the amount of the earnings of the acquired company but some other amount, perhaps more, perhaps less, as the case may be.

Entries Upon Payment of Stock Dividends

Now we come to a question on which we have been, as I said we would be in Colorado Springs, very greatly attacked, the position of the Stock Exchange on stock dividends.

I know of no more difficult subject, that has bothered accountants in recent years. The laws of our states to which I have referred in regard to the determination of the amount which may be considered capital and the amount which may be considered capital surplus, have led many corporations to start with capital surplus many times larger than the stated capital.

It represents a part of the consideration received for or represented by the stock. I think we could state this subject much more clearly, think of it much more clearly, if we thought of it in terms of stated capital and unstated capital instead of in terms of capital and capital surplus, and it has appeared to us (and there is an official announcement of the

Stock Exchange to that effect) that when considering it, all periodical stock dividends ought to be charged against earnings or earned surplus. The public takes them, all such small stock dividends, regular periodical stock dividends, as an evidence of income.

Whether they are economically sound or not, the small holder sells his scrip rights to such dividends and treats it and looks upon it in all respects as the equivalent of a cash dividend, and there should be made against the earnings of the acquired company a proper charge.

A stock dividend may be earned and wrongly accounted for. It may be earned and rightly accounted for; it may not be earned at all. A split-up, stated as such, is recognized as legitimate. But where any portion of a stock dividend, so-called (and many for reasons of expense and other reasons are pure split-ups which are issued under the guise of stock dividends)—wherever a stock dividend represents anything else than an evidence to the stockholder of the earnings of the corporation, the current earnings of the corporation, the fact ought to be stated in a notice accompanying the dividend to the stockholders.

Now because of the fact that the distinction between capital and capital surplus is a most tenuous and arbitrary one, the Exchange feels that there should be charged against earnings in the event of the issuance of stock dividends, a sum per share issued equal to the combined capital and capital surplus per share prior to the issuance and that the amount should be credited either to capital, or if it is desired to preserve a stated capital at the same amount or in the cases of par value stocks where there is no choice as to that matter, that it should be represented in part by transfer from earned surplus to capital surplus.

There are some considerations determining the propriety of a stock dividend. With many of those accounting as such has nothing to do. From an accounting standpoint I feel that a stock dividend is earned when the total book value of the

stock after the date of issuance is greater—as great as or greater than it was after the last similar dividend issue, with due allowance of course for any intervening financing.

Now this subject is of importance. We have had in regard to listed companies nine different methods approved by accountants for handling the entries under this subject come before us and they are not all right because some of them are in direct conflict with each other.

Entries Upon Receipt of Stock Dividends

Passing from the question of the entries upon the payment of stock dividends we come to the question of the entries, upon the receipt of stock dividends, by recipient corporations.

The subject is of a great deal of importance because there are large companies which pay all or a great portion of their dividends in stock.

Those companies are perfectly proper holdings for investment trusts which are among our very large investors. If the old rule is to be maintained, that a stock dividend merely, no matter what the circumstances of its issuance, serves to increase the number of pieces of paper which you have in your hands representing the equity you own in the corporation, there comes a bar, which is not justified, in the minds of investment trusts against buying the stock of corporations from which they can get no income which they may properly take up upon their books. And it has seemed to the Stock Exchange, and it has so stated publicly, that there is no objection as to any corporation owning securities in a stock dividend-paying company, to taking up upon its books at the time of receipt, irrespective of sale, whether the stock in question is sold or whether it is not sold, as an earning, an amount equal to the pro rata amount for the stock received by it, charged against earnings by the issuing company. More than that we feel would be unsafe, first because if based upon market price it depends upon a future transaction in which a third party is involved, namely a seller, as to whether such

profits are ever realized; secondly, if within a smaller amount because any amount not charged against earned surplus by the issuing corporation remains as earned surplus available a second time for declaration in the form of a dividend, either cash or stock, without further earnings and sooner or later we feel the recipient of that dividend will be misled if he takes upon his books more than the amount of the charge made by the issuing company. This feeling of the Stock Exchange goes to the point of having an agreement with all corporations now applying for listing, in which they agree, that they will not take up as income stock dividends received at more than the amount charged in relation thereto by the issuing company.

I am fully aware of one difficulty with which you are confronted, in the practice of the profession (and there will be chaos if you ever get away from it) and that is, not to take up earnings until the date of realization. We all know that earnings may be spread over a period of years before they are realized; but all accounting conventions provide that they shall be taken up upon the date of realization.

The whole emphasis of this particular position of the Exchange rests upon the fact that we conscientiously believe that the receipt by the stockholder of an evidence of his equity in earnings of the company in the shape of a negotiable instrument, namely, the stock certificate (not, perhaps technically a negotiable instrument but a negotiable security) constitutes realization.

If your clients sell goods to John Jones and Company and take a ninety-day note you take your profit quite properly upon your books at the date of the consummation of the sale and the acknowledgment of the indebtedness. The note is not cash any more than a stock certificate is cash. Any subsequent transaction is a separate transaction which may then involve a loss. And so we regard the receipt of this negotiable security by the recipient as being realization to the extent and only to the extent of the amount charged against earnings or earned surplus by the issuing company.

That position, of course, is attacked from both sides. I have received and read more than one hundred pages of single typed matter since that address was delivered, protesting against allowing it to be taken up at all, from one man. He is an enthusiast; and I have received most interesting and informative discussion from one of your members, urging that the policy of the Exchange is not sufficiently liberal in that respect. I indulge at least in the hope that a position which is attacked from both extremes may not be very far from the facts, although I admit that it is a most difficult situation. But I wish that I could see accounting practice crystallized at least to the degree of not allowing any more than that amount to be taken up as earnings by the recipient company.

Over-Conservatism in Accounting

I want to issue you a caution against over-conservatism in accounting. I do not think that is the job of the accountant. Of course we all know that accounting is not an exact science. I doubt if there are any two really competent accountants who would go over the books of a large corporation for a considerable period of time separately and produce an identical result. Two beginners might possibly do it but I do not think experienced men would. Nevertheless, there are limits of accounting accuracy, and as I see it, it is not the job of the accountant to be over-conservative; neither is it his job to be under-conservative. It is his job to be as accurate as his sense of what has happened permits him to be, and his judgment permits him to be.

I think we are too apt to delude ourselves into the thought that over-conservatism can do no one any harm. That was true when, as I stated in the beginning of this address, accounting was primarily for the benefit of management who knew the facts anyhow (though I never could see just what advantage they got by fooling themselves) and their creditors. A creditor cannot be hurt by an over-conservative statement, but a stockholder may be badly hurt by an over-conservative statement. In the first place, if he believes it, he may sell his

security for much less than it is worth; in the second place, generally he does not believe it. Rumors spread that such and such a corporation has large concealed earnings, and it seems to me that the investor always magnifies their maximum amount many times in his mind, during a period of prosperity, at least, and so such securities tend to reach a height of market price during such periods, which is harmful to all concerned and particularly of course to those who invest during that period.

So I would ask of you that you consider your own consciences as to whether you are doing the proper thing when you append without qualification your certificate to a statement which you know to be over-conservative. If you have to err, it is better to err on the side of conservatism than it is on the side of radicalism; but the question is, why err at all if you know the truth?

Equity of Parent Company in Subsidiary Company Profits

One more question of a general nature before I deal with some of the newer questions which have presented themselves, the question of a parent company taking up subsidiary companies' profits or rather its equity in subsidiary company profits on parent company income account and reflecting them in the investment of the parent company in its subsidiary company stocks. I am aware that there is a decision which in the case, I believe, of a wholly owned subsidiary virtually without extraneous obligations of any kind, has ruled that the substance and not the form counted, and that there was no objection. That may be so under such instances, but reflect, if you will, that after all earnings are evidenced by assets acquired; that the title to the assets is in some corporate entity; that the title to the assets of a subsidiary company not distributed in the shape of cash or otherwise in a form of dividends, remains in the subsidiary company, and while it is quite proper to include these in the consolidated statements, I can conceive no reason in the world why such profits should

be taken up upon the books of the parent company. In fact, I have been advised by most eminent counsel that under many jurisdictions, directors of a holding company or parent company declaring dividends, based upon such book entries, may, at the instigation of creditors be held personally liable for the dividends so disbursed.

We would not take the interest we do in this subject if we had not seen instances of the apparent abuse of minority stockholders, and thereby the parent company getting the benefit of 100 per cent of its equity in the earnings, while the minority stockholders of the subsidiaries get nothing; the parent company borrowing from the subsidiary companies the money with which to pay its dividends; the subsidiary company showing a beautiful position, with a heavy surplus and wonderful quick assets (never having declared any dividends) consisting entirely of the parent company notes which represent money theretofore disbursed to the stockholders in the form of dividends and the subsidiary companies marketing their securities at an unduly favorable rate of interest on account of their fine position. That is high finance, gentlemen, and I hope that you will not find it within your province to endorse it.

Reacquired Securities

During the last year we have heard a great deal about reacquired securities. Many companies have taken into their treasuries their own reacquired stock, for various reasons. There are certain circumstances under which there is no possible objection to the reacquisition of its stock by a company. I am talking now particularly — well, I am talking of all classes — industrials, investment trusts, and everything else; but the Stock Exchange insists, when brought to its attention that stock has been reacquired, that such stock shall either appear (as we prefer it) as a deduction from the stock issued upon the liability side of the balance sheet, or if treated, as custom sanctions, upon the assets side, that the number of shares of each class of stock reacquired should be shown

separately in order that the investor may know at all times, or at least at the time of every presentation of a report (a formal report) just how much stock there is outstanding in the hands of the public.

Now then comes a very important question about which there is much difference of opinion among accountants. We cannot see the reason for that difference of opinion. We have given the matter careful thought, study and consultation. It is the question of profits, if any, upon such reacquired securities.

It is perfectly manifest that if a corporation reacquires its own bonds at less than the sum which it would have to pay upon maturity that there is a real profit, because bonds are in a determinable amount, payable at a determinable date, and the cancellation of that indebtedness for a smaller amount involves necessarily an item of profit which may be used in various ways, either as a direct, separate entry to income, specified (it should always be disclosed, we feel) or perhaps for the wiping out of the discount and expense of the remaining issue of bonds, or other matters of that sort. At all events, it may perfectly properly be treated as profit; but we do not feel that any profit made upon buying and reselling its own preferred or common stocks is in any sense an earning.

In the first place, the Exchange is very much opposed to a corporation trading in its own stock, although it recognizes that a company may reacquire its stock under perfectly proper conditions; that conditions may change and it may therefore be justified in selling that stock. That is an occasional transaction and not trading as such; but when such a transaction results in the corporation receiving more than the sum which it paid for the stock, or when it reacquires its preferred stocks, we will say, having a par value at less than that par value, we feel that a corporation simply cannot make a profit dealing in its own securities; that when it acquires the securities they are temporarily at least retired, and the capital of the company is reduced thereby; and when they are reissued they are issued as though in the first instance.

While the corporation may have an absolute right to determine the amount, and has a right under the laws of most states to determine what amount of the consideration finally received it will call capital and what amount it will call capital surplus, we feel that that difference is an increment to either the capital account or the capital surplus account, but in no event to the earnings account.

During the year the management type investment trust listed upon the Exchange had their troubles, and arising out of the great fall in the price of securities many new accounting problems were presented. A great many of the corporations in question found it necessary to provide reserves; some wrote down their securities, with our assent, which we are sorry we gave, because we doubt the advisability of substituting an accidental figure as of a certain date for the historic figure of cost. The provision of reserves is all right, and to make the reserves conform, if you wish, as nearly as may be to market value.

It is doubtful, although we have said nothing against it, whether it is wise to write down the securities to market value. At all events, out of the provision of reserves and so forth, there came up questions as to accounting.

Trading Gains or Losses

Now, the Exchange sets its face very strongly, when such reserves are created, against showing the realized profit on the sale of securities in the income account and charging the realized losses against the reserve. We feel that is perfectly proper, where a reserve has been set up, to show both earnings realized and realized losses in the income account, and thereafter to transfer from a reserve provided for that purpose, an amount sufficient to preserve the surplus of the company intact; but we do not feel that it is proper to take the gains into the income account and the losses not to be shown. We feel that that is very misleading, and that no matter what kind of a footnote or other explanation there may be (there are so many people who read accounting statements hastily)

there is the gravest danger of misunderstanding if the practice is adopted.

Another thing on which we have pretty strong views is the question of the determination of the amount of the trading profits. We know of four different ways of accounting for profits or losses on securities sold. It is true that the subject is complicated a little bit by the fact that apparently some corporations use all four simultaneously as may best suit the purpose.

Those four methods may briefly be described as first in, first out, last in, last out, average cost and particular lots, with a sub-division of the last for the considering of securities purchased at a high level as being permanent investments and securities purchased at a lower level as representing a trading account, with the further thought that should the judgment again prove wrong and the market further decline, the first trading account becomes a permanent investment and a second trading account may be established.

Of course there is an occasional justification of particular lots, the only one of which we can think being where securities are bought under a repurchase agreement and are sold under that agreement; manifestly that agreement applies to that particular lot, and any gain or loss under it should be so treated. Apart from that we feel that the method of average cost is the only method which does not distort the true situation.

Without going into or taking up your time tonight to the extent of enumerating just what the objections are (I am sure they will be apparent to you anyhow) all of the other methods are liable to very serious objections at times, and may most seriously mislead the stockholder. The thing is important because of the fact that after all, as I said a while ago, with most of the decent corporations regular dividends on common stock are seldom paid for any time excepting out of earnings, and therefore, the question of "what is earnings?" constitutes a most important topic.

At least we feel that if any other method than average cost is adopted, the method must be shown; and if any change has been made, or more than one method has been used during a year, that that fact must be recited in the annual report. I hope that we may secure the full cooperation of your profession in that matter.

Our Committee has pretty well decided, and in talking over the matter with the officers of many investment trusts has so stated, that we greatly prefer that an investment trust should not take up realized gains or losses, trading gains or losses, through its income account at all. We feel that such realized gains or losses are much better credited, preferably to a reserve; but if not to a reserve, to a special item of surplus so described; and that losses should be charged against that reserve. Of course if at any given time the total of losses exceeds the total of realized trading gains, then necessarily you would not show as a matter of good practice, that debit reserve upon the assets side of your balance sheet but necessarily as a deduction from earned surplus.

We feel that particularly in matters of senior securities it is important to preserve and to show to the stockholder the amount available for their dividends, received by the investment trust from dividends and interest on the securities held and from other items of actual current revenue; and that as to the common stockholder, it is important to show earnings in a way which will dispel the illusion that realized trading gains form a basis or may form a basis for permanent dividends.

Right here, in case anything of what I am saying tonight should get outside, I want to draw a very careful line between the position of the Exchange officially on this subject, which is as I have just stated, and a position I hold myself, and I want to make it plain that in what I am about to say there has been no action by the Exchange approving it. However, I want the consideration of a body of men like this on the subject now to be outlined, because I think I am right and

I would like there to be more thought on the subject than there has been.

I am personally opposed to the inclusion of realized trading gains and losses in the income account, because I do not think that accounting has progressed to the point, nor do I think it ever will progress to the point, where it can determine when such so-called profits are real profits. Economically, they may be, and they may not be. I can best make my point clear, I think, by a simple illustration. Supposing an investment trust had the opportunity at a given moment to buy stock in corporation A at $80 a share and in corporation B at $100 a share, and supposing that the price movements thereafter were governed solely by changes in the price earnings ratio, and not by differences in the relative circumstances of the company or the relative earning power of the company.

The corporation in question elects to buy, we will say, 100 shares of corporation A stock at 80, or $8,000. It goes up 25 per cent. The corporation sells it for $100 a share and gets $10,000. According to all rules of accounting that I know of, that will be taken up, as it gets the cash, as a realized gain of $2,000. In the meanwhile corporation B has likewise gone up 25 per cent, and is now 125. The corporation now buys eighty shares of that stock.

Then both again go up 20 per cent, the one to 120, the other to 150. The stock in the second corporation now goes up to $12,000. There is another realized profit of $2,000. Now say the stock is sold and goes back into 100 shares of corporation A. You have exactly the same number of shares that you had in the beginning—80; you have not a cent of cash additional. You have simply made two transactions, each of which gave you a $2,000 profit upon your books, and you have exactly the security with which you started.

Have you made a real profit? If you have disbursed that cash in dividends to your stockholders where have you got-

ten it? If there are no other transactions you must have gone in debt for it or issued additional capital securities.

Take another case, a corporation buys a stock of a given company believing it is worth 130—buys 100 shares at 100, or $10,000. It goes quickly up to 150, and the corporation sells it. According to all accounting rules, a profit of $5,000 is entered upon the books. Then it goes down to 130, which is what the corporation thought it was worth at the beginning, and the corporation buys it back. It has now the original 100 shares of stock and $2,000 in cash. That $2,000 in cash is real profit. There it is genuine; but you have on your books $5,000. Of course, there are circumstances, many of them, where all of the profit is real. For instance, take a very simple one where you borrow $10,000 to buy securities which you sell for $12,000. If you pay your debt you still have $2,000. There is no question that that is all profit. But the point I make is that without a system of intricate cross accounting, which would be beyond the power of man, it is most difficult to determine when those profits are real profits and when they are not. In thousands of instances they are all real; in other thousands of instances they do not seem to me to be real; and the question arises, is it not far more conservative and better practice to segregate all such balances representing apparent earning from realized trading gains in a reserve for the protection of and reinvestment for the original stock of the corporation, and not to disburse them at all in dividends, excepting at such times, if any, as the corporation, finding itself in excess of funds which it can use to advantage, decides that it would under other circumstances return a portion of its capital to its stockholders?

I gravely question the conservatism of dividends from trading profits. The English, you know, do not do it. As I understand it (and I believe I am reliably informed) no English investment trust disburses such realized trading profits in the form of regular dividends to its stockholders; and I can conceive of the possibility, during a period of long expansion of market prices, of such profits mounting and being

disbursed in dividends, resulting in higher and higher capitalization; yet the net real result to the company being that it has only returned to its stockholders the sums received from other stockholders for additional cash to meet its reinvestment at these higher levels in a substantially unchanged portfolio.

At the end of this discussion of the character of trading profits, I wish to emphasize, as I did at its beginning, that it represents only my own personal and unofficial views which have been presented solely for the purpose of provoking such thought upon the subject as may aid in the determination as to whether these views are sound.

Gentlemen, I am very much obliged to you for your attention.

RULE OF THUMB DEPRECIATION RATES

By Max Rolnik, C. P. A.,
of Leslie, Banks & Co.

THE MERITS and faults of general depreciation rates are well illustrated in *Depreciation Studies,* a preliminary report recently issued by the Bureau of Internal Revenue. The setting of depreciation rates cannot be satisfactorily done in the factory office by examining plant ledgers or at the Bureau office by examining plant schedules. This must be done in the factory itself by examining the assets, how they are built and how they are used. Two assets of similar type will have widely varying rates depending on the quality of their construction, on the speed and duration of their operation, the care and maintenance they receive and the likelihood of their having to be replaced on account of their inadequacy long before they are physically useless. As a practical necessity, however, standard rates are useful, if for no other purpose than as a rough measuring stick with which to check the rates in particular cases. That is all that is claimed for *Depreciation Studies,* as it is all that can be claimed for any list of depreciation rates.

Some three thousand separate items of plant assets are listed in the Bureau's report, each with its average depreciation rate. By far the greater number of these assets are arranged by industries in which used. Items common to many industries or which cannot practically be classified by industries are separately listed. The report, while hardly original, should prove useful for taxpayers and Government agents provided it is used with judgment.

The fault with most depreciation lists, as well as the Bureau list, is that the description of the types of assets is too indefinite. In our using such lists, assets listed as automobiles, barges, steam turbines do not permit us to compare our particular asset of those types. Likewise terms such as average conditions and ordinary use are deceptive, for there is no way of comparing a specific situation with one described

in such a general way. The opinion of even recognized authorities of the depreciation rate for, say, a "building, hotel, steel construction, fire proof", is not as valuable as the opinion of a lesser authority of the rate for the hotel at 100 Main Street, New York. The writer recently had a case with agents of Bureau of Internal Revenue involving the question of the depreciation rate for a particular building. Ample authority for both the taxpayer's position as well as the Government's position could be found in various published depreciation lists. What finally clinched the matter was a case decided by the Board of Tax Appeals involving the depreciation of a certain building in the locality of the one in question. This building was not identical, but it could be inspected and there was some basis for satisfactorily reconciling the depreciation rates for the two.

Some of the inconsistencies in the rates given by the Bureau for certain assets under the various industrial classifications are probably ascribable to the fact that the persons making up the rates for one industry did not have in mind exactly the same asset which is similarly described under another industrial classification. It is not sufficient, for example, that factory buildings be separated into their general types, i. e. frame, steel, etc. They must be further classified into many subdivisions, depending on the quality of material and labor that goes into the construction of each general type. One building may be built in a first-class way, to stand up well under hard usage, while another building of exactly the same type may be built in a shoddy way. The thickness of walls, class of roof, type of foundation—these and other elements of construction affect the depreciation rate. It would have been better if the Bureau instead of giving the average rate for an "automobile truck", for example, gave the rate for a Ford truck of a certain type or a Mack truck of a certain type. Where one has an authoritative rate for a specific asset that he may actually inspect and compare with the one he is setting a rate for, even though the two items are not identical, he can intelligently adjust the published rate. But how can

one compare his truck with the *average* of trucks? Similarly with lathes, motors, engines and the thousand other general types of items.

In the same way, it would have been more satisfactory if instead of assuming that the assets are operated under "ordinary" conditions, the Bureau's rates assumed operations under specified typical conditions. There is always a wide difference of opinion as to what the term ordinary conditions implies. The classification by industry by the Bureau is very desirable, but it would have been much more useful to have a consensus of opinion of rates for a specific concern in each industry, giving a description of its size, class of goods handled, location, etc. Then one could compare his particular plant with the one described and determine whether it required higher or lower rates than those given.

During the past few years, with the publication of numerous decisions of the Board of Tax Appeals, the accountant has obtained much more valuable material on depreciation rates than he heretofore had. This is due to the fact that now he has more clearly described assets and conditions of operations instead of only general names of assets and no idea as to the conditions of use.

The Bureau's rates were prepared with the cooperation of trade associations and individual taxpayers and there must have been differences of opinion among those who submitted their recommendations. These differences necessarily have been ironed out in the setting of an average rate for each type of asset, but it would be interesting to know how this adjustment was made. Until we know this, the Bureau's list is of less weight than many that have been prepared by accountants and tax services. In the case of the latter, some authority at least is often cited and by reference thereto we may learn, by the description of the item, the factors considered and the logic of reasoning, whether the rate appears reasonable or not.

Five years ago, when the Bureau announced its commencement of work on *Depreciation Studies*, the writer looked forward with great interest to the results and hoped that there would be published something original and scientific. Instead we have a compilation, more comprehensive than any heretofore published by private persons it is true, but otherwise not any better. With the mass of available data on depreciation which the Bureau has, it should have done some scientific work, for example, such as was done in recent years by Robley E. Winfrey on the life of automobiles and by Edwin B. Kurtz, who made such a brilliant study of mortality of physical properties. Perhaps we will have such studies later, after the Bureau's work of preparing a practical working manual for taxpayers and Government agents is out of the way.

SOME ASPECTS OF THE TRAINING OF JUNIOR ACCOUNTANTS

By Paul E. Bacas, C. P. A.,
of Acker, Bacas & McGirl

THE TRAINING of junior accountants is a very broad subject if it is discussed from the viewpoint of public accountants in general. It is difficult to make definite suggestions on this subject which will appeal to each reader. This may be visualized when it is considered that the reader will have in mind a certain junior or prospective junior and will endeavor to apply the suggestions to that individual. Needless to say the individuals the various readers may have in mind will vary considerably in their personalities, educational qualifications and capabilities. The requirements of the public accountants in question, their temperaments and their viewpoints will vary to a more marked extent.

A discussion of the training of the junior accountant therefore should be developed with the thought that the junior must meet the requirements of several public accountants, that of the large firms as well as the small practitioner.

The first question which should receive attention must necessarily be the qualifications of the prospect. He should have at least a high school education. It might be added that he should be a graduate of a recognized school of commerce. It would seem that he should have a certain amount of business experience and of necessity understand bookkeeping from both the theoretical and practical viewpoint. The junior finds himself at the very beginning in the midst of records and data and business procedures of which he should have a certain understanding. It is very difficult for the junior to make even the most elementary decisions unless he has been in direct contact with the records, data and procedure through business experience of at least a year or two.

The fact that a large part of the work of the public accountant must be completed during a relatively short season makes necessary the engagement of many temporary men the ma-

jority of whom may be classed as juniors. These men find themselves going from one organization to another and usually for short periods. These men have received a certain amount of training but it develops that the training is practically useless and in some cases a handicap when the junior joins a new organization.

This condition is due in large part to the lack of uniformity in the demands of the public accountants when the new junior is engaged. It may be said that the lack of uniformity is a result in part of the fact that the public accountants have no definite standard or yard stick to apply to the prospect. Another reason for the lack of uniformity is that too often the public accountant engages the junior having in mind primarily the requirements of a definite engagement to which the junior is to be assigned. The fact that the man who may obtain the best results in the long run on the various engagements handled may not necessarily make the best impression on the peculiar engagement which is in mind is not considered.

When a junior is to be engaged the public accountant usually will have in mind that he wants a man who can do the sort of work which a certain senior did when he came to them. The years that have passed since that time probably make it very difficult to bring the mind back to the requisite point in the development of the man in question. If this were possible the personal characteristics of the individual would make it difficult to measure the qualifications in question in terms which might be applied to another man.

Would it not be a vast improvement on the present methods if it were known that a man who was recommended by his previous employer or employers had received at least elementary training along lines which were generally accepted by reputable public accountants? If the majority of the public accounting offices followed the same procedure with the new juniors undoubtedly many men who now go from one accounting office to another would be eliminated as material for permanent public accounting work by the first employer.

Many of the large accounting firms have definite schemes of instructions to acquaint the junior accountants with some of the procedures followed in their organizations. However, these firms usually find that during the busy seasons they must engage temporary men for practically immediate use and there is very little time for instruction.

It is very likely that the instructions received in the large accounting offices vary considerably. If a junior trained in one large office connects with another large office it is probably necessary to spend considerable time acquainting him with the methods of the second organization.

It would therefore seem that the large accounting organization would gain from the adoption of some plan whereby a certain amount of uniformity might be achieved in the training of junior accountants. As to the smaller organizations there is no question but that their gain would be considerable. The junior accountant would have a greater respect for the ability of his superiors and the clients might appreciate to a greater extent the benefits of engaging well trained public accountants.

It will be assumed that the junior accountant who is to receive the training has the qualifications mentioned hereinbefore.

The training of the junior divides itself into two parts:

(a) That which he may receive at the office through special instructions in preparation for his duties in the field.

(b) That which he receives during the course of his work in the field.

Even in the large organizations it is rather difficult to control the instruction which the junior receives while in the field from the senior accountants. It would seem, however, that if the senior had obtained his early training through definite instructions, if in addition the senior had worked with others similarly instructed he would be more likely to give the junior

instructions which would be largely in agreement with the procedure followed by others in his organization.

It is, however, in the instruction which the junior receives in his office that much may be done through concerted efforts on the part of the profession as a whole.

The committee on the training of junior accountants should be a clearing house for information on this subject. It is also likely that the committee, with the assistance of some of those who have had special experience on this subject and who are interested in the training of junior accountants might develop a procedure rather restricted at the beginning, which could be used in whole or in part by many public accountants and which being in use over a period of time might be amplified and become the accepted procedure of a majority of the members of The New York State Society of Certified Public Accountants.

RECOMMENDATIONS FOR REVISION OF NEW YORK STATE TAX LAWS

Prepared and Submitted to the New York State Commission for the Revision of the Tax Laws by the Committee on State Taxation of The New York State Society of Certified Public Accountants

New York State Commission
for the Revision of Tax Laws

Gentlemen:

IN ORDER to assist the Commission in its efforts looking toward a revision of the system of taxation in the State of New York, this memorandum is submitted by The New York State Society of Certified Public Accountants. As we see it, the problem of the Commission may be divided into two sections:

1. The allocation and equalization of the tax burden to the various sources of taxation such as
   - (a) Real estate
   - (b) Personal incomes
   - (c) Corporate franchise and corporate business
   - (d) Special business and occupation in the form of license taxes, sales taxes, etc.

and

2. The equalization and proper apportionment of the tax burden between those taxable in each of the foregoing groups.

This memorandum deals exclusively with corporation franchise tax matters and the recommendations herein are designed to equalize the tax burden in such a manner that it shall be reasonably distributed among those subject thereto.

We submit this memorandum not as advocates of any group or as spokesmen for any particular industry, but solely with the object of correcting inequalities, removing ambiguities and eliminating unjust and unfair results caused by vari-

ous provisions of the law and the administrations thereof which have brought extensive criticism of both.

By reason of the wide, varied and continued experience of the members of the accounting profession in the State of New York with tax returns, both of the State of New York and the Federal Government, and in many, if not all, of the other states of the Union, and our experience in the administration of the laws under which such taxes are determined and assessed, we believe our suggestions along these lines may prove very helpful.

The principal ambiguities, difficulties and inequalities seem to lie in the taxes assessed and collected from corporations in the form of corporate franchise and income taxes. This condition is, we believe, largely the result of the fact that corporate franchise taxes have been amended and changed in piecemeal fashion year after year, without a complete study of the entire system of corporate taxation.

The suggestions we have to offer and the recommendations we make are for the purpose of equalizing the taxes on corporate business, preventing improper evasion of taxation, and eliminating the unequal burden placed on different corporations.

If the recommendations contained herein will result in the reduction of tax—and most of them will not have such a result—the aggregate yield from corporate taxation can be maintained through higher rates. The adoption of these recommendations would tend to achieve one of the objects of your Commission, namely, to "provide for New York State a system of taxation which shall reasonably distribute the tax burden as widely and evenly as possible", and would provide a more equitable tax system. We also believe that ultimately a more equitable tax on corporations would result in increasing the tax revenue in that it would tend to attract corporate business to the State of New York instead of driving it out of New York as it is now doing.

We make no suggestions or recommendations regarding rates as those must ultimately be determined on the basis of the distribution of the general tax burden among the principal tax revenue sources hereinbefore mentioned.

The attached memorandum is submitted for your careful consideration.

Yours very truly,

COMMITTEE ON STATE TAXATION
Harold E. Bischoff
Walter A. M. Cooper
Joseph Getz
F. Cornelius Wandmacher
Marvin D. Waters
Isidor Sack, *Chairman.*

Memorandum of Recommendations

1. Franchise Tax or Income Tax?

The legal theory underlying the tax on business corporations under Article 9a of the Tax Law is that it is a tax on the franchise to do business, the value of the franchise being measured by the income of the corporation for the calendar or fiscal year preceding the franchise year. For example, the income of a business corporation for the year ending December 31, 1929 will be the basis for the tax for the franchise year beginning November 1, 1930, and ending October 31, 1931, and the tax will be payable on or before January 1, 1931.

The administration of what is in theory a franchise tax, but what is for all practical purposes an income tax* results in a number of complications, and in occasional hardships and inequalities, and also on frequent occasions, in a loss to the State of taxes which would be collectible if the law were in theory, what it is in fact—an income tax.

* Cardozo, J. in People ex rel Alpha Portland Cement Company vs. Knapp et al, 230 N. Y. 48: "tested by these precedents, the tax imposed upon this franchise must be held in practical operation to be a tax upon the income . . . I think, therefore, that in substance though not in form, in tendency though not in name, this tax is equivalent to a tax upon the realtor's income . . ."

The State cannot collect a tax from a corporation going out of business before October 31st of any year, upon the income of the corporation for the fractional part of the year in which it went out of business or for the fiscal year preceding. In order to prevent evasion, Section 214a was enacted, reimposing this tax upon the purchasing corporation if a corporation going out of business should sell all its assets or franchises to another corporation. The tax is lost, however, if the assets are not sold to another corporation subject to tax in this State, and Section 214a has had the effect of imposing an unjust tax where corporations legitimately and *for full value* acquired all or part of the assets of some other corporation.

We recommend, therefore, that the tax on business corporations be made a straight income tax and that it be required that all income be subjected to taxation as such regardless of when the corporation may cease to do business. In order, however, that corporations that do not earn any income should not go free of tax but pay a fair proportion of the corporate tax burden for the privilege of doing business in a corporate capacity, we suggest that the present alternative tax on corporations based on the value of the capital stock (segregated in a manner similar to that used for the segregation of income) be retained as an alternative minimum tax.

We also recommend in connection with the alternative minimum tax upon corporations taxable under Article 9a, based on the value of capital stock, that it be measured in all cases by the *actual value* of the capital stock *and not* as at present *on the par value* in case of a corporation having stock of a par value, or actual value in the case of a corporation having no par value stock (Sec. 214, Subdivision 10). It is obviously inequitable to permit a corporation having say $100,000 of capital actually paid in and used in the business to be taxable in the one case on $10,000 because $10,000 par value of stock has been issued therefor, and in the other case on $100,000 if stock without par value has been issued.

2. Classification of Business, Holding and Real Estate Corporations

The franchise tax on real estate corporations is now based on the value of the gross assets employed within the State (Sec. 182), the franchise tax on holding corporations is based on the amount or value of the capital stock within the State (Sec. 188), and the franchise tax on business corporations is based on income allocated to this State (Sec. 209), with a series of minimum taxes as provided by Section 214, Subdivision 10.

The distinction between business corporations, holding corporations and real estate corporations is sometimes difficult of precise ascertainment, and if one corporation combines the functions of two of these classes of corporations, it is then taxed entirely as a business corporation. In practice, for example, a corporation which is predominantly a real estate corporation is classed as a business corporation and taxed as such, when surplus funds are invested in securities. This results in confusion as to the franchise year, the date for filing the return and inequity in taxation.

We believe that these various classifications of corporations and the varying bases of tax are the result of legislative history rather than of any sound legislative policy or intelligible theory.

We recommend that all these classes of corporations be taxed upon income. We express no opinion about the rate of tax. If, however, the Commission is of the opinion that income from different sources should bear different rates of tax, all similar income should be taxed alike to all corporations regardless of the classification of the corporation. For example, if your Commission is of the opinion that income from real estate should bear a lower rate of tax than income from other sources, then all income derived from real estate should be taxed at one rate as well to a corporation whose real estate ownership is *part* of its activities as to a corporation whose real estate holding constitutes its *sole* activity. It is a

simple accounting matter for corporations to segregate income from various sources, and the income derived from real estate, by a corporation that owns real estate and also carries on other business, can be readily and accurately ascertained. There should be no advantage accruing from shrewd and elaborate forms of organization which the present law inevitably suggests to informed counsel. The *source of the income* and not the nature of the corporate structure should determine the tax.

We further recommend that the franchise year and the date for filing returns should be made uniform for these three classes of companies. Under the practice of the Tax Department a corporation may involuntarily have its status changed from one year to another, and the varying franchise year periods result in overlapping taxation and confusion as to the form of return to be filed.

3. Minimum Tax

Section 182 provides for a minimum tax of $10 on real estate companies; Section 188 provides for a minimum tax of $10 on holding companies, and Section 214 provides for a minimum tax of $25 on business corporations.

We recommend that the minimum tax as such be repealed, and that in lieu thereof there be imposed a uniform filing fee, payable upon the filing of the return. This would fix definitely the date of filing the return, and would obviate the necessity of assessing, billing and collecting taxes where no more than the minimum amount is due. (See also, discussion under heading "Payment of Tax", number "13", hereof.)

4. The So-called Third Minimum Tax

Section 214, Subdivision 10 of the Tax Law relating to business corporations contains three provisions for minimum taxes, one of which is a tax of "not less than would be produced by applying a rate of four and one-half per centum to a base found by using the following formula: From the sum

of the entire net income and salaries and other compensation paid to all elected or appointed officers, and/or paid to any stockholder owning in excess of five per centum of the issued capital stock of the corporation, deduct as a specific exemption the sum of five thousand dollars and any net loss for the reported year. From the sum so found an exemption of seventy per centum thereof shall be granted and the remainder shall be used as the base of the tax." Obviously this basis is altogether arbitrary and is probably designed to relieve the tax commission of the burden of deciding the reasonableness of salaries paid by corporations, and to substitute a mechanical formula for the exercise of discretion.

This provision has resulted in inequitable and burdensome taxation to three classes of companies: (1) personal service corporations, such as realty brokers, advertising agencies, etc., (2) small corporations whose principal activities are carried on by the officers who own most of the stock of the corporation and (3) corporations whose operations are comparatively unprofitable.

In the case of personal service corporations and small corporations which are in effect the incorporation of a partnership of two or three persons, the tax is unduly heavy and is far in excess of what the tax would be if the business were conducted in partnership form and amounts to an inequitable discrimination against doing business in corporate form. As soon as taxpayers become aware of the unfair burden of this provision it is not unreasonable to expect that many corporations will be dissolved and the business conducted in partnership form, denying to small businesses the convenience of doing business in a corporate form, for no valid reason based on any ascertainable public policy.

There is no sound basis for this discrimination, and in numerous instances, which have come to the attention of the various members of this Society, the tax on this basis is far in excess of the Federal corporation income tax.

The inequitable burden of this provision in the case of companies who have suffered a net loss is obvious. Instead

of bearing easily upon such companies who already have to bear the misfortune of business losses through business hazards, depressions and the like, the State of New York adds a burdensome and discriminatory tax.

5. The Segregation Formula

Section 214 of the Tax Law contains a formula for allocating to the State of New York, and subjecting to the tax under Article 9a, a portion of the income in the case of corporations conducting business within and without the State. The proportion is based upon the ratio of what are called "segregated assets" within the State compared to the total of all "segregated assets".

The statutory formula fails to meet the first test of equity, namely, to be a formula which if adopted by all states in which a corporation carries on business would subject 100% of the corporation's income—*and no more*—to taxation.

Some of the elements used in the statutory formula overlap, so that if several states had the same formula, the corporation would be taxed by the various states in which it did business on an aggregate of more than 100% of its net income. This is particularly true with respect to the second item of the formula, which includes, as a "segregated asset" within the State, the value of bills and accounts receivable arising (1) from personal property manufactured within the State, (2) personal property not manufactured within the State but located within the State at the time of the receipt of the order, and (3) personal property not manufactured or not located within the State but arising from sales accepted by any officer at any place of business within the State. If we assume the case of a corporation having a factory in one state, a warehouse in another and a sales office in a third, the adoption of the New York State formula requires the inclusion of all bills and accounts receivable as taxable elements in the returns of all of the three states, if they had similar laws.

Another serious objection to the statutory formula lies in the fact that the elements used are not such as are ordinarily

ascertainable from the books of accounts as usually kept. The ascertainment of the information required by the law, if conscientiously attempted, requires analyses of miscellaneous records, and in many cases, the adoption of hypotheses or guesses.

The principal criticisms of the second item of the formula, therefore are:

First, that the data required for the application of the formula is not produced by books of account as usually kept.

Second, that it is not equitable in apportioning the fair share of income as between New York State and other states wherein the corporation may do business.

Another element in the segregation formula is the proportion of the value of the stocks of other corporations owned by the corporation "allocated to the State as provided by this Section." (214 of the Tax Law). The reporting corporation has no means of knowing what such allocation of value is, or whether it has been lawfully and correctly determined, and it has therefore, no means of knowing whether one of the factors used in determining its own tax liability is correct. It is not always possible to secure this information from the Tax Department promptly enough to prepare returns within the period required by law.

The Special Joint Committee on Taxation and Retrenchment in its report years ago criticized this rule of apportionment as follows:

> "**The apportionment of interstate income.**—The present rule of apportionment for dividing the net income of corporations doing business in other states as well as in this State has been the object of sharp criticism, much of which, in the opinion of the Committee, is justified. The rule, now in use, divides the income on the basis of the relationship of the value of the corporation's property in New York to the value of its property everywhere, the precise character of the property entering into the formula being carefully defined. The proper allocation of income from interstate income is one of the most difficult and complicated problems in the whole field of State income taxation. It is, moreover, highly important to the corporations that the allocation rules of the various states imposing income taxes be consistent and uniform in order that, in the aggregate, not more than 100 per cent of their income be subjected to taxation."

Nothing, however, has since been done to correct this, and the inequities of the apportionment rule and the criticism thereof have both grown.

We recommend for consideration of the Commission the simple formula adopted by the State Tax Commission in the administration of the personal income tax law. This formula prescribes as factors: (1) the average value of real property and tangible personal property connected with the business at the beginning of the year, (2) total wages, salaries and other personal service compensation paid during the year to employees in connection with the business, and (3) the gross sales and charges for services performed. The ratio which the New York total of these factors bear to the total of all factors determines the ratio of income taxable to the State. The data for this formula is easily secured from books of account as commonly kept, and results in a fair apportionment to the State of the income presumably arising from business done within the State, in the case of a corporation doing business in several states.

The law should also provide that where the income actually earned within the State of New York can be separately determined by the corporation, or the Commission, without regard to any segregation formulas, the income so determined shall be the basis for the New York State tax.

As the State Tax Commission adopted that formula, where it had the discretion to adopt one under the statutory powers, it presumably regards that as the more suitable one than the statutory formula written into Article 9a of the Tax Law. This is very similar to the method used in Massachusetts.

6. Consolidated Returns

The provision for consolidated returns is contained in Section 211, Subdivisions 9, 10 and 12, and Section 214, Subdivision 7, of the Tax Law. These provisions do not prescribe any definite method for consolidating returns or for determining consolidated income, but generally give the Tax Com-

mission the discretion to require consolidated returns where corporations are affiliated, and in addition give the Commission broad powers to adjust the tax in such manner as it shall deem to be equitable. Section 211, Subdivision 12, of the Tax Law provides that where a real estate corporation is controlled by a business corporation, and all or part of the real estate is used by the business corporation, said corporation becomes subject to the tax under Article 9a and consolidation with the affiliated corporation may be required. The law does not determine how the tax is to be computed under such circumstances, the entire determination of the tax being left to the discretion of the Tax Commission without any legislative direction.

We believe that this is an unwise condition in the law. A corporation's tax liability should be defined by law and not left to the discretion of the Commission, particularly where no legislative limits or standards are set. In practice it has been observed that corporations similarly situated have been differently treated.

The problems presented by affiliated corporations are complex. The Federal government has had many years of experience in the taxation of affiliated companies, and has laid down definite rules prescribing the circumstances under which affiliated companies may file a consolidated return. On the other hand, the State Tax Commission has formulated no rules by which the right or duty of affiliated corporations to consolidate may be known in advance, so that a taxpayer corporation may readily ascertain its tax liability.

We recommend that specific rules, similar to those contained in the Federal statute, be prescribed so that corporations coming within the scope of the definition of affiliations (which should be prescribed by law) shall have the absolute right to file consolidated returns. The law should state the basis for determining the tax where a company, taxable under Article 9a, is affiliated with and files a consolidated report including a corporation taxable under Article 9.

We recommend that the right or liability to file consolidated returns, and to have the tax determined upon a consolidated basis shall be fixed in the law, and that the State should follow the Federal practice of giving the corporation the option of filing a consolidated return or of filing separate returns.

7. Net Loss Provision

For nine years the Federal law has permitted a corporation to deduct from the income of one year the net loss of the two years previous.

Under the State law a corporation with a net loss still has to pay a tax based on the value of its capital stock and cannot apply the net loss against income of any succeeding year.

We recommend that the State follow the Federal practice by permitting corporations to deduct from the income of one year the net operating loss of the two years previous so that if a company has a good year following one or two bad ones, the tax shall be evened out rather than be accumulated in the profitable year without any benefit by reason of deductions of prior losses.

8. Equitable Powers of the Tax Commission

Section 211, Subdivision 11, of the Tax Law provides that: "if it shall appear to the Tax Commission that the segregation of assets shown by any report made under this article does not properly reflect the corporate activity or business done . . . or the income earned from corporate activity, or from business done in this State because of the character of the corporation's business and the character and location of its assets, the Tax Commission is authorized and empowered to equitably adjust the tax upon the basis of the corporate activity or the business done within and without the State rather than upon capital or assets employed."

Section 209 provides in part as follows: "However in determining the entire net income for the purposes of equitable taxation under this article of the Tax Law, the Tax Commission may

include income from any source, provided only that the assets from which the income arose shall be included in any segregation for the purpose of computing the tax."

There is no provision in the law determining or limiting the range of discretion to be applied by the Commission and these sections apparently give the Commission blanket power to assess the tax on any basis it determines equitable without any opportunity to the taxpayer to challenge the basis. We believe this is a dangerous and unsound statutory provision and an abdication of legislative power. The liability of corporation to tax should be more closely defined and the range of discretion should be specifically limited so that corporations shall have rights as well as liabilities.

The Committee takes the position that every taxpayer is entitled to be informed as to what his legal liability is. A corporation should be in a position to determine before it starts to do anything or enters into any unusual transaction what its tax liability would be. This result is not possible under the law as it is now administered, particularly in view of these miscalled equitable provisions.

There is no parallel or similar provision in the Federal law; on the other hand, the Federal law once contained a discretionary power on the part of the Commissioner to *reduce* the tax of individuals and corporations where the statutory basis might seem to the Commissioner to be unduly burdensome by comparison to the tax imposed on other corporations similarly situated. The instant provision is not one which works to reduce the statutory tax liability but only to increase it. This is a practical transfer of the taxing powers from the Legislature to the Tax Commission, which we believe to be unwise and should be repealed.

9. Taxation of Investment Holding Companies and Investment Trusts

The segregation formula contained in the Law (Section 214) is not at all adapted to apportioning the income of invest-

ment holding companies and investment trusts, which do business within and without the State, and which own securities of companies doing business in the State and companies which do not, and the Tax Department is itself in doubt as to the fair basis for taxing these companies.

We have observed several instances where large investment trusts have established offices outside of the State, and do their banking and keep their securities in vaults without the State, all of which needlessly drives business from New York State without achieving any corresponding benefit. In fact a prominent New Jersey trust company has been advertising regularly concerning the advantages in keeping funds and securities in New Jersey and thus reducing the New York State tax liability. The investment and depositing of monies, the purchase and sale of securities can so easily be conducted without the State, that in the opinion of the Committee, it is poor policy to leave the tax liability of these companies in an uncertain condition and thus drive business away from New York.

We recommend that the basis of taxing this class of companies, if at all, should be reconsidered and a basis adopted which will be suitable to investment trusts, one which is clearly defined and which will not have a tendency to drive the business of these companies out of the State.

10. Taxation of Corporations Acquiring Assets or Franchises of Other Corporations

Section 214a provides that: "If any business corporation shall acquire either directly, indirectly or by merger or consolidation the major portion of the actively employed assets or the franchises of another corporation, the income of the acquired corporation shall be added in determining the taxable income for the basis of taxation of the reporting corporation."

This section was undoubtedly introduced in order to prevent illegal evasion of the tax by subterfuge. In practice, however, it has been applied to tax corporations who legiti-

mately and for full value acquire all or part of the assets of some other corporation not affiliated with it, and find themselves taxed upon a profit which never accrued to them, and thereby in effect required to pay an additional price for assets for which they have already paid the full market price.

This is a burden which does not arise in the case of the acquisition of assets from an individual or partnership, and there is no equitable reason for imposing such a burden where assets are acquired from a corporation.

If the tax is made a true income tax and not a franchise tax as is recommended hereinabove, this section will become unnecessary and should be repealed. If, however, the franchise tax theory of the law is retained we then recommend that this provision should be amended so as to cover only the acquisition of assets by merger or consolidation in which the ultimate ownership by stockholders is substantially unchanged and not by outright purchase for value.

11. Administrative Matters

There has been widespread criticism of the practices of the State Tax Commission in administering franchise taxes caused by arbitrary practices, delays in the determinations of assessments, sometimes extending over a period of years, diverse treatment of similar situations and failure to grant a fair opportunity for appeal from the tax assessment without recourse to the courts.

We make the following recommendations:

(1) That the Commission be required by law to promulgate and publish regulations and leading rulings governing the franchise taxes.

(2) That the period during which an assessment may be made shall be limited to a date not more than two years from the date of filing the return except where the income has been changed by the Federal audit in which case there should be no time limit for additional assessment or refund.

(3) Where the return is disregarded in whole or in part the Commission should be required to attach to its assessment a statement of the computation of the assessment and the basis thereof.

(4) That a Review Board or Commission independent of the State Tax Commission or at least independent of the Corporation Tax Bureau, be created to which appeals from decisions of the Commission can be made without requiring recourse to the Courts.

We call attention to the fact that under the present law appeals from decision to the Commission in respect to franchise tax matters can be made only to the Appellate Division situated in Albany. This imposes a burden of expense and inconvenience to most people in the State, which induces them to submit to an unjust and unfair assessment rather than to incur the expense of securing judicial relief.

If such a Board or Commission is created it should be required by law to hold hearings in any judicial district elected by the Appellant.

12. Revision and Readjustments of Accounts

Sections 198 and 218 provide for the revision of accounts if application is filed within one year from the time the tax is assessed.

We recommend that the period for filing claims for revision be extended to two years, to conform to the practice prevailing under the Federal Income Tax Law. We further recommend, that where a claim for revision is based on a decision of court nullifying either a provision of the law or a construction thereof by the Tax Commission, that the claim may be made within one year from the date of the decision. The corporation tax-payer that acquiesces in the law or in the construction thereof by the Tax Commission should not be placed in a situation less favorable than that of a corporation which contests either, and wins after a lawsuit.

We also recommend that the law provide that upon application for revision of an assessment the corporation taxpayer may request a hearing either at Albany or any first class city, or in the judicial district in which its principal office is located. The practice of the Tax Commission in holding hearings on claims for revision of corporation taxes only in Albany (a practice which differs from its own procedure with respect to other taxes) results in unnecessary expense and hardship, and creates avoidable resentment against the law and the administration thereof.

13. Payment of Tax

The tax should be made a self-assessing tax and the amount of tax should be made payable at the time of filing the return. If the law were simplified and regulations were published from which the law could be understood, the determination of the tax would be a matter of no great difficulty. This would relieve the Corporation Tax Bureau of the work of assessing and collecting every tax, and would confine it to the job of auditing and verifying returns and making assessments or refunds only in such cases where the tax had been erroneously computed in the first instance. The reduction which would result in the work of the Corporation Tax Bureau might enable it to decide more expeditiously than it now does, the cases involving question and controversy.

The tax is payable on January 1st or 30 days after the date of assessment. As in many cases the assessments are not made until after December 1st, it is obvious that the change herein recommended would result in the earlier receipt of the revenue by the State.

THE INCREASING BURDEN OF OVERHEAD EXPENSES

From the March 30, 1931, Bulletin of the Department of Manufacture, Chamber of Commerce of the United States, Washington, D. C.

BUSINESS firms everywhere are confronted with the necessity for recognizing the increasing importance of overhead expenses. In many lines of manufacturing, for instance, analyses have shown that profit margins have been narrowed by the encroachment of overhead expenses upon earnings while material and labor costs have remained stationary; whereas in other industries in which profit margins have been maintained, there has been a shifting in the relative importance of the various cost elements so that overheads represent an increasingly larger proportion of total costs. The problem is present in all types of business, however, and is not limited to the manufacturing field alone since, in the field of marketing, the same tendencies are apparent.

The causes for the increasing importance of overheads may be attributed (1) partly to the progressive evolution of business from simple to more complex organizations, and (2) partly to the inability of business management to coordinate properly the functioning of a particular plant or industry in harmony with the general economic structure of business.

Under the first group of causes may be included:

(a) Increased use of machinery.

(b) Progress of mechanical invention and scientific research which render old machines and processes obsolete and inadequate.

(c) Tendency to establishment of large organizations.

(d) Demand by consumers for numerous "free" services and accommodations.

(e) Increased cost of government as reflected in higher tax burdens.

In the second group of causes may be included:

(a) Over-expansion of plants through over-ambitious sales programs.

(b) Wasteful utilization of facilities and resources.

(c) Inability to adjust organizations to new conditions.

(d) Failure to establish adequate controls over expenditures and to provide coordinated planning.

Brief consideration of these general factors may help to explain why overhead costs are becoming increasingly important in business; and why, in developing adequate control of business activities through cost accounting, they must be kept in mind. It is only through analysis and study of the fundamental services rendered and by appraising properly the value contributed by each factor in overhead expense that control and ultimate reduction of these costs may be attained.

Greater Overhead from Increased Use of Machinery

As the services of labor are supplanted by mechanical processes, and machines are put to do the work formerly performed by human hands, additional fixed capital investments are required. With each addition of buildings, machinery, or equipment to the plant account, certain expenses increase. The value of the investments in fixed assets must be absorbed in product costs by charges for depreciation and obsolescence; the necessity for proper maintenance involves expenses for repairs; the protection of the investment against loss by fire and other contingencies must be assured through the placing of proper insurance coverage; the increased asset value must be included in tax assessments and additional taxes paid. For the cost of one item of labor replaced by a machine, a dozen other costs are substituted. Usually labor costs can be allocated to products without serious difficulty, because only one cost element is involved. When labor is replaced by mechanical processes, however, and labor costs are supplanted by a

dozen indirect costs, the allocation of these costs to specific products become extremely intricate. Each of the new costs must be analyzed carefully in order that it be distributed equitably in proportion to the value contributed to each class or unit of product.

The result is that with each substitution of mechanical processes for hand methods, the problem of proper cost allocation becomes most involved. Unit costs of product, however, are generally, though not necessarily, reduced.

Overheads Resulting from Obsolescence of Machines and Processes

As inventive genius, through its experimental and research laboratories has placed more efficient machines and processes at the disposal of industry, the problem of obsolescence has assumed greater importance. Old plants have been abandoned in their entirety because improved processes have made operation of such plants unprofitable due to excessive costs of production. The production of many products has been eliminated entirely because science has provided something better.

The rapid progress of invention in lines such as the automobile, radio and cinema industries bears evidence of the problems arising from obsolescence. Machines unsuited for the fabrication of a newer product must give way for improved types.

The cost of the old machines remains, in many instances, as a capital charge. Regardless of the accounting treatment given such a charge, this cost must be recognized in the total costs of production as depreciation, or as a charge against earnings.

Overhead Problems in Consolidations and Mergers of Organizations

Much attention has been directed to the consolidation and merger of organizations for the purpose of effecting economies

in operations. Price advantages through quantity purchasing; cost reductions from large-scale production methods; elimination of duplicate plants, inventories, channels of distribution, and administrative functions; and possibilities of more effective advertising, have been advanced as some of the benefits to be derived from consolidations.

In many cases, however, the expected economies have not been attained. Economies which have been made in production processes have tended to be offset to some extent by increased expenditures for non-manufacturing functions. Selling, advertising, accounting, statistics, research, and other similar activities have become more specialized, and have required larger appropriations. There has been a tendency for these activities to become unwieldy. The inauguration of a great multiplicity of functions in the form of "service" activities has added further burdens to total costs of doing business. The result has been that the administrative sections of large organizations have become expensive and any economies attained through large-scale production methods have been dissipated through wastes in marketing and office practices.

It is sometimes forgotten that a large-scale enterprise is not necessarily more economical to operate than several small enterprises having a combined capacity equal to the one large unit. Limitations of space prevent detailed discussion of this point, but attention is directed to consideration of generally recognized limitations and disadvantages inherent in large scale organizations, and to a consideration of that principal which economists label "the law of diminishing returns." Recognition must be given to the fact that profits do not necessarily increase in direct relation to increasing volumes of business done.

Overheads Increase with Demands for Services

There is no business in existence today which is not confronted with the problem of rendering services of many kinds for which no direct remuneration is received. As competition

has increased, the numbers and types of such services have become multiplied.

Manufacturers have increased the number and nature of warranties given with their products. Installation and repair services have been offered in many instances without adequate recompense for the costs involved. Generous guaranties against defective parts and workmanship have entailed costs far in excess of original estimates. To meet demands for prompt delivery, products have been shipped by express whereas only freight costs have been considered when setting selling prices. Under pressure of keen competition, discounts and credit terms have been allowed contrary to the dictates of conservative practices.

Gasoline filling stations, banks, department stores, hotels, railroads, and other agencies appealing directly for the patronage of the consuming public have provided innumerable services as incentives toward procuring trade. We expect free air for our tires, water for our radiators and batteries, and expect our windshields washed every time we stop at a filling station to buy gasoline for our cars. When we drive up to a department store we expect a liveried attendant to drive away our car to a parking place provided by the store, and then have the car waiting at the door when we have finished shopping. Our packages must be delivered promptly regardless of their size or value. Our banks must provide us with checkbooks, and with periodic literature regarding business conditions, with advice on investments, with legal counsel, and allow us to overdraw our bank account at will.

In its desire to serve customers effectively, modern business has built up an almost endless array of expensive practices. Overhead expenses have mounted and profit margins have decreased. Yet business has seemed unwilling to curtail the insistent demand for these services. Under the stimulus of an intensely competitive system, individual operators have vied with each other in encouraging trade by providing ingenious and unique types of services, but have disregarded gener-

ally the increasing overhead costs incurred, and have not realized that excessive multiplication of services might prove uneconomical. Only as profit margins have narrowed or disappeared, has attention been directed to scrutinizing each such service as to its value in contributing to sound business methods, and as to its direct or indirect contribution to the profit account.

The Increasing Overhead of Taxes

The insistent demand for services has penetrated to our governments. More and more, governmental agencies have increased their scope of activities and their budgets of expenditures. National, state, county, municipal, and other bodies have placed an increasing financial burden upon communities and upon industry. Legislative bodies during the past decade constantly have been making proposals for finding ways and means to pay for the increasing burden of government. Income taxes, sales taxes, franchise taxes, luxury taxes, capital gains taxes, and numerous others having been added to the older forms of property taxes may operate to provide additional channels for diverting business and personal funds into the coffers of the public treasuries.

Taxes most certainly become an onerous overhead cost, and the ingenuity of individual management can avail little toward its reduction. Practically every other item of overhead can be reduced by intelligent, effective management, but taxes are a cost difficult to reduce or adjust. It is a fixed overhead in amount, and it tends to increase year after year.

Over-Expansion of Individual Plants and Sales Programs

In the intensive struggle for markets, and in the urgent desire for volume, individual operators have been prone to over-build production facilities. Sales quotas have been established on the basis of productive capacity rather than in view of the ability of a particular market to absorb the products made. Too much blind faith has been placed in the principle

that unit costs of production would be lowered by increasing the volume of output, and too little analysis has been made of overhead costs in respect to their variability under differing conditions of volume. Many individual operators have failed to realize that there might be a limit to the reduction of unit overhead costs, and that for every increase made in the volume of production there might not be a proportionate increase in net profits.

When the high sales quotas could not be attained, the actual volume of commodities produced has been manufactured at a higher cost than anticipated, because of the necessity for absorbing the overhead costs of operating facilities at less than estimated productivity. Decreased profits have followed.

Overheads Due to Wasteful Practices

It is to the credit of American industry that it has made noteworthy progress toward the simplification and standardization of many lines of products. By concentrating production on a small number of products in each line of industry, substantial savings have been made through the more effective utilization of machinery and by the possibility of manufacturing in larger quantities. By these processes, also, the various distribution agencies have been enabled to carry smaller inventories, and to concentrate more thoroughly upon the sale of fewer articles.

Much remains to be done, however, since industry through its continual application of newer and more improved methods is constantly adding to the number and variety of products available. On the other hand, human inertia hinders the recognition and adoption of corrective measures, and thus increases costs of production through wasteful utilization of labor, machines, and other services.

Overheads Because of Mal-adjustment to New Conditions

Regardless of the rapid trend of invention toward the improvement of machines and processes, many individual

operators have been slow to adopt effective measures which would be economical, and, accordingly, have lost significant competitive advantages. General adoption of more effective production methods, marketing plans, and administrative controls have come slowly. Failure to study carefully the needs of various classes of consumers before production is started has resulted in accumulations of slow-moving inventories containing products unsuited to general market demands. Continuation of production after the demand for a product has ceased further clogs the channels of distribution with useless products and accentuates the problem of over-production.

Control of Expenditures and Operations

Business has made some progress toward providing management with effective methods for controlling the operation of individual businesses, and for determining policies under varying economic conditions. But further development of such methods, and more general acceptance of them are necessary. Dissipation of human energy in every phase of activity from the extraction of natural resources to the marketing of finished products; wastes in the utilization of resources; improper coordination of activities toward the attainment of maximum effectiveness; and failure to recognize increasing expenditures of various cost elements, arise from lack of adequate methods of control.

Regardless of the type of activity engaged in, budgeting and cost analysis are devices which can serve as effective tools of management in the shaping of policies and in the directing of operations to conform with such policies. Whether the activity is concerned with extraction of natural resources, with fabrication of products, with storing and distribution of commodities, or with rendering of specialized services, these two management tools can be adapted effectively to the individual situation. Proper budgeting establishes in advance the plan of operation and sets the standards to be attained. Adequate accounting and cost analyses disclose the results of operations

and direct attention to the specific causes and sources of wastes, and to variations from the predetermined plan.

In the face of many evidences of increasing overhead expenses, resulting from the causes discussed briefly above, adequate knowledge and control of costs are essential. Cooperative efforts by particular industries, through their trade associations, toward development of uniform methods of cost accounting, can be of substantial worth in disclosing inefficient practices, and in establishing standards of performance for the industry. Cost factors and control problems confronting each individual plant in an industry are essentially similar for the industry as a whole. Failure to recognize these similarities has led to much unintelligent competition.

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